Office of Chief Counsel
Internal Revenue Service

memorandum

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te: JUL 1 4 1999

to: Chief, Examination Division, Southwest District
Attn: Vickie Kearon 4202PHX

m: District Counsel, Southwest District, Phoenix

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ct: **Taxpayers:** [redacted]

Costs of [redacted] spinoff of [redacted]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals ecipient of this document may provide it only to those persons /hose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether certain types of expenses incurred by [redacted] and [redacted] during [redacted]'s [redacted] spin-off of [redacted] are deductible by the taxpayers.

2. If such expenses are not deductible, whether they are amortizable.

CONCLUSION

1. Such expenses related to the spin-off are not deductible by the taxpayers.

2. Such expenses related to the spin-off are not amortizable by the taxpayers.

FACTS

On [redacted], [redacted], which was then known as [redacted], spun off its consumer products division, which is now known as [redacted], in a tax-free transaction qualifying as an I.R.C. § 368(a)(1)(D) reorganization. Prior to the transaction, [redacted] obtained a private letter ruling to ensure that the reorganization would qualify as a tax-free transaction. This transaction also received much press locally, due to [redacted] being a major local employer. The reasons for the spin-off have therefore been memorialized, both in the facts of the request for a private letter ruling, and in quotes included in news articles. From these sources, as well as corporate minutes, the main reasons for the spin-off appear to be:

1. The old [redacted] had a low price-to-earnings multiple due to its being a conglomerate.

2. Both the consumer products and service businesses within the old [redacted] had to conduct any expansion through debt rather than equity under its circumstances at that time.

3. A spin-off, it was believed, would raise the price-to-earnings multiple for both companies.

4. Such factors, it was believed, would result in a greater total stock value after the spin-off.

5. The new [redacted] would be able to expand its business after the spin-off with a public offering of new stock (equity), rather than through more debt.

On its [redacted] income tax return, [redacted] deducted $[redacted] in spin-off expenses, and capitalized about $[redacted] in expenses relating to the name change from [redacted] to [redacted]. [redacted], on its [redacted] return, deducted about $[redacted] in spin-off expenses, and capitalized about $[redacted] in incorporation fees, stock issuance fees, and other similar expenses relating to its new status as an independent entity. Such expenses included items such as consultant and accounting fees for both [redacted] and [redacted], as well as expenses for such miscellaneous items as for development of a new corporate logo to go with the new corporate name, and stock issuance fees.

You have asked whether, under the circumstances set forth above, expenses relating to the spin-off can be deducted by the old or the new company. For the reasons set forth below, we believe that [redacted] and [redacted] are not entitled to deduct expenses related to their reorganization, nor are they entitled to amortize such expenses under I.R.C. § 197.

DISCUSSION

1. Any discussion of this issue must start with a review of INDOPCO v. Commissioner, 503 U.S. 79 (1992). In that case, the taxpayer attempted to deduct investment banking fees related to the taxpayer becoming a subsidiary of another corporation in a friendly acquisition. In disallowing this claimed deduction, the Court noted that deductions are exceptions to the norm of capitalization, and are allowed only if there is a clear provision for them in the Code. Citing its opinion in Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971), the Court stated that to qualify for a deduction under I.R.C. § 162(a), an item must be paid or incurred during the taxable year, be for carrying on a trade or business, be an expense, be necessary, and be an ordinary expense. The Court further indicated that Lincoln Savings stands for the proposition that an expenditure that serves to create or enhance a separate and distinct asset should be capitalized under I.R.C. § 263; it does not mean that only expenditures that create or enhance a specific asset are to be capitalized. The Court determined that while "the mere presence of an incidental future benefit . . . may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." The Court found a significant long-term effect for the taxpayer, indicating that expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary expenses.

Subsequent courts have nonetheless noted, and in fact the INDOPCO opinion acknowledged, that the decisive distinctions between current expenses and capital expenditures are those of degree and not kind, and that the mere presence of "some future aspect" may not warrant capitalization. INDOPCO v. Commissioner, 503 U.S. 79, 86 (1992). See also Connecticut Mutual Life Insurance Co. v. Commissioner, 106 T.C. 445, 453 (1996). The relevant inquiry therefore does not end at whether the taxpayer realized benefits beyond the year in which the expenditure occurred, but requires additional query into the duration and extent of those benefits. See, e.g., Black Hills Corp. v. Commissioner, 73 F.3d 799, 806 (8th Cir. 1996).

The information provided strongly supports a conclusion that the benefits of the spin-off for both [redacted] and [redacted] extend well beyond the year of the spin-off. The request for private letter ruling discusses change in business strategy, from acquisitions to divestitures. The request further references increasing price-to-earnings ratios as a major reason for the transaction, as well as the ability to grow through equity rather than debt. While the spin-off might have created a short-term boost in stock price, all stated rationales for the spin-off appear to focus on the long-term benefits of the deal. As noted in Norwest Corp. v. Commissioner, 12 T.C. No. 9 (Mar. 9, 1999), expenses incurred in reorganizing or restructuring a corporate entity are generally for the purpose of betterment of corporate operations for the duration of its existence, or at least for a time somewhat longer than the current taxable year. This therefore appears to be a situation in which most, if not all, of the benefits of these expenses would have been anticipated to occur over the long haul. For example, unless a particular deal was in the works, the ability to fund acquisitions through equity rather than debt would be an advantage that would pay off on all those future dates in which acquisitions were actually made. Such advantages of reorganizing are the type that ordinarily provides long-term benefits. While we are extremely curious as to the taxpayers' explanations for deducting these items, we nonetheless believe that the substantial majority of any benefits extended well beyond the year of the spin-off, and that expenses related to the spin-off generally are not deductible by either [redacted] or [redacted].

2. I.R.C. § 197(e)(8) provides that any fees for professional services or transaction costs incurred by parties to a transaction to which any portion of the gain or loss is not recognized under part III of subchapter C is generally not amortizable. I.R.C. § 368(a)(1)(d) is within part III of subchapter C. As indicated in the House Report on P.L. 103-66 (see 1993-3 C.B. 167, 346), this provision addresses a concern that some taxpayers might contend that the 14-year amortization period (ultimately passed as a 15-year period) provided by section 197 applies to any such amounts that may be required to be capitalized under prior law but that do not relate to any asset with a readily identifiable useful life. Because such reorganization costs do not relate to any asset with a readily identifiable useful life, such expenses, which were not amortizable prior to enactment of § 197, are not now amortizable because of § 197.

Please note, we consider the opinions expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding the above, please contact me at (602) 207-8052.

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